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Approved by:
Peter O. Kurz
U.S. Embassy, London

Prepared by:
Steve R. Knight

Report Highlights:

UK production of cigarettes is forecast to remain at just 126 billion pieces in CY2002, of which over one half are expected to be exported. At this reduced level of production, and as in CY2001 and CY2000, UK demand for unmanufactured tobacco will remain diminished. However, estimates indicate low stock levels. As such, an increase in imports is forecast this season. Around 30 percent of the UK's adult population, or 15 million people, smoke with a total annual duty-paid expenditure of around USD18 billion. However, this is not the full story as the high taxes on tobacco in the UK allegedly fuel a tobacco black market. It is estimated that in CY2001 taxes were not paid on an estimated 33 percent of all cigarettes smoked.

Includes PSD changes: Yes
Includes Trade Matrix: Yes
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Explanatory Notes

Stocks

The format of the production, supply and demand (PSD) tables for cigarettes featured in this report makes no allowances for stocks. The trade information is, therefore, distorted when it is reported in the PSD and in turn affects the supply and distribution totals. To remedy this problem the actual market conditions are described in separate tables within the body of the text. References to market data therefore relate to these tables and not the traditional PSD tables which for cigarettes can be found in the statistical appendix.

Exchange Rates

This report refers to sterling's competitiveness against other currencies. The following table provides yearly average exchange rates for sterling against the U.S. dollar and the Euro. The latter currency replaced the European Currency Unit (ECU) on 1 January, 1999 and entered full circulation in the participating European countries on 1 January, 2002.

From 1996 through 1999 sterling appreciated in value relative to the ECU/Euro and the U.S. dollar. However, since 1999 sterling's value against the dollar has been in steady decline. This has gone some way to increasing the competitiveness of UK tobacco products on export markets in recent times. However, on the EU market fortunes have been more mixed, sterling's value against the Euro fluctuating.

EXCHANGE RATES		
Year	ECU per BPS	USD per BPS
	(Euro per BPS	
	for 1999 onwards)	
1994	1.2897	1.5316
1995	1.2070	1.5785
1996	1.2286	1.5610
1997	1.4431	1.6393
1998	1.4789	1.6570
1999	1.5192 (1)	1.6179
2000	1.6419	1.516
2001	1.6084	1.4405
2002 (2)	1.6281	1.4306
(1) Euro superceded ECU from January 1, 1999		
(2) January - April 2002 average		
Source: Bank of England		

Note: Throughout this report the rate of exchange used is BPS 1 = USD 1.43

Executive Summary

The structure of the UK tobacco industry is dominated by three national companies – Gallaher Ltd, Imperial Tobacco Ltd and British American Tobacco (BAT), the latter operating as Rothmans (UK) Ltd on the domestic market. All three predominantly produce cigarettes but also manufacture hand rolling and pipe tobaccos and cigars. While Gallaher and Imperial have traditionally dominated the domestic market, BAT has traditionally concentrated on the export of cigarettes which it manufactures in the UK. However, in recent months BAT has started to take more of an interest in the domestic market while, conversely, Imperial and Gallaher are increasingly turning their attention to the international market.

This report focuses on unmanufactured tobacco and cigarettes, the two most important elements in the UK tobacco market. Although the UK imports all of its tobacco leaf, it is a substantial exporter of finished tobacco products, mainly cigarettes, to the Far and Middle East and Eastern Europe. In CY2001 the UK tobacco export market was worth around BPS920,000 (USD1.15) billion, a 9 percent decline on CY2000 directly attributable to a reduced cigarette export volume. This is a continuation of a trend which first emerged in the late 1990s following the economic downturn in the Far East. With domestic consumption of duty-paid cigarettes also in long-term decline, the sector is under some pressure. However, the UK's main export markets are showing some signs of recovery and, as such, producers have maintained production at around 126 billion pieces in CY2001 and increased cigarette stocks in the hope of increased exports in CY2002. It is thought that this approach has depleted stocks of unmanufactured tobacco and increased imports are forecast for CY2002. UK cigarette production is expected to remain at around 126 billion pieces in CY2002 with any increase in export demand being met from the large stocks of cigarettes held in the UK.

There are currently some 15 million adult smokers representing about 30 percent of the adult population in the UK. Total duty paid consumer expenditure on tobacco products passed BPS12.5 (USD17.9) billion in CY2001, this being spent on 55.7 billion cigarettes, 2,775 tons of hand rolling tobacco and 892 million cigars. However, these figures may mask the true total UK expenditure on and consumption of tobacco products as many consumers turn to personal or black market imports. For example, officially reported UK cigarette sales to the trade have declined 39 percent since 1993. In reality cigarette consumption has remained fairly steady at around 84 billion pieces with non-duty paid consumption of cigarettes on the increase. Indeed, CY2001 consumption of non-duty paid cigarettes is thought to have accounted for around a third of the total.

UK taxes on tobacco products, which generate around BPS10 (USD14.3) billion per annum, amount to over 3 percent of all UK government taxation. With the highest incidence of tobacco tax in the EU, the tax (excise duty plus value added tax) currently accounts for just over 84 percent of the price of the leading brand of cigarettes in the UK. Consequently, UK tobacco prices are among the highest in the world. Although cigarettes can cost almost three times as much in the UK as in other EU countries such as Spain, it is the difference on hand-rolled (RYO) tobacco that is most marked, with popular brands costing between four and five times more in the UK than they do in Belgium. While government initiatives to stop smuggling may curb the illegal imports somewhat, tobacco price differentials between the UK and other EU countries will continue to provide incentives to smugglers and UK tobacco product consumers. Government anti-smoking initiatives may eventually reduce domestic consumption but these figures are not expected to decline by much in the near future.

Unmanufactured Tobacco

PSD Table

PSD Table						
Country	United Kingdom					
Commodity	Tobacco, Unmfg., Total				(HA)(MT)	
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		01/2000		01/2001		01/2002
Area Planted	0	0	0	0	0	0
Beginning Stocks	105352	25352	83000	22398	57000	14554
Farm Sales Weight Prod	0	0	0	0	0	0
Dry Weight Production	0	0	0	0	0	0
U.S. Leaf Imports	3764	3764	4000	1206	0	4000
Other Foreign Imports	104663	104663	100000	101460	0	115000
TOTAL Imports	108427	108427	104000	102666	0	119000
TOTAL SUPPLY	213779	133779	187000	125064	57000	133554
Exports	10944	10944	10000	10510	0	10500
Dom. Leaf Consumption	0	0	0	0	0	0
U.S. Leaf Dom. Consum.	3500	3500	3750	1000	0	3750
Other Foreign Consump.	116335	96937	116250	99000	0	97000
TOTAL Dom. Consumption	119835	100437	120000	100000	0	100750
TOTAL Disappearance	130779	111381	130000	110510	0	111250
Ending Stocks	83000	22398	57000	14554	0	22304
TOTAL DISTRIBUTION	213779	133779	187000	125064	0	133554

UK imports of unmanufactured tobacco fell a further 5.4 percent in CY2001, down for the fifth year running largely as a consequence of the reduction in the production of cigarettes in recent years. Brazil, Zimbabwe, India and Italy remain the UK's greatest suppliers with most of Italy's leaf being transhipped product from Sri Lanka and India. Leaf imports from the U.S. fell sharply in CY2001. Revisions to historical stock numbers indicate that they are likely becoming increasingly depleted. As such, CY2002 is forecast to see some recovery in import demand which should benefit U.S. exporters.

UK exports of unmanufactured tobacco are small, generally remaining between 10,000 and 11,000 tons with most of this product being exported to France and Ireland. CY2002 is forecast to be no exception to this ongoing trend.

UK consumption of tobacco leaf stabilized at just over 100,000 tons in CY2001, reflecting the stabilizing of cigarette

production in the UK. With cigarette production forecast unchanged and imports expected to rise in CY2002, the drawdown in stocks seen in CY2001 is not expected to be repeated in CY2002. Rather, an increase is forecast.

Trade Matrices

Import Trade Matrix			
Country	United Kingdom		
Commodity	Tobacco, Unmfg., Total		
Time period	Jan - Dec	Units:	MT
Imports for:	2000		2001
U.S.	3764	U.S.	1206
Others		Others	
Brazil	23292	Brazil	44131
Zimbabwe	22539	Zimbabwe	20041
Italy	10151	Italy	4331
India	9573	India	3843
Belgium Lux	5541	Belgium Lux	3642
China	4445	Spain	3003
Spain	4072	Canada	1974
Argentina	3279	China	1950
Uganda	3066	Uganda	2315
Tanzania	3045	Tanzania	2009
Total for Others	89003		87239
Others not Listed	15660		14221
Grand Total	108427		102666

Export Trade Matrix			
Country	United Kingdom		
Commodity	Tobacco, Unmfg., Total		
Time period	Jan - Dec	Units:	MT
Exports for:	2000		2001
U.S.	2	U.S.	17
Others		Others	
France	4251	France	4175
Ireland	4022	Ireland	3605
Russia	600	Singapore	576
Netherlands	318	Bangladesh	521
Cote d'Ivoire	300	Cambodia	271
Canada	297	Netherlands	225
Spain	211	Kazakhstan	218
Germany	160	Greece	203
Rwanda	154	Rwanda	137
Singapore	137	Ghana	101
Total for Others	10450		10032
Others not Listed	492		461
Grand Total	10944		10510

Cigarettes

	1999	2000	2001	2002 (f)
Opening stocks	273215	628298	659186	875142
Production	134568	126105	126141	126000
Imports	382597	71801	246145	85000
Exports	100349	111006	100607	1031142 (2)
Duty-paid consumption	61733	56012	55723	55000
Private/Illegal Imports	22000	28000	28000	29000
Total consumption	83733	84012	83723	84000
Closing stocks	628298	659186	875142	1031142
(1) Total available to export/re-export during 2002				

Production

UK cigarette production is estimated at 126 billion pieces in CY2002. This is unchanged on both CY2000 and CY2001 following some revisions to the historical data. Although domestic consumption of duty-paid cigarettes is forecast to continue to decline due to the ongoing high tax policy and anti-smoking campaigns in the UK, some recovery in export demand is forecast in line with the recovery of the Far Eastern markets and the competitive sterling versus U.S. dollar exchange rate.

Consumption

The UK cigarette market continues to be characterized by down trading. As the price of duty paid cigarettes has risen, such that a twenty packet of a premium brand now costs around BPS4.50 (USD6.45), cigarette smokers have unsurprisingly looked for alternatives.

While some have turned to purchasing smaller packets (purchases of packets of 10 cigarettes have grown 2 percent in the last two years to 18 percent of the market in CY2001) others are seeking out alternatives to their usual brands. For many, this has meant down trading from premium to middle-priced brands, although in a lot of cases this has been a temporary move before the inevitable move to an economy or ultra-low price brand.

The major companies have reacted to consumer demand for cheaper cigarettes by launching their own economy brands, which have proved very successful. Imperial's Richmond brand, for example, was launched two years ago and now accounts for BPS700 million (USD1 billion) in sales and is continuing to grow rapidly. Gallaher's low-priced Dorchester brand is another success story. Relaunched in new packaging early last year, this brand has reportedly seen

65 percent growth year-on-year. According to industry estimates, the lower priced sector now accounts for around 50 percent of the total duty-paid market and is likely to keep growing.

However, many trade down even further to smuggled cigarettes, where premium brands cost just over half the price of the legal equivalent and nearly BPS1 (USD1.43) lower than the cost of the lowest ultra-low price brand. Indeed, such is the success of the cigarette black market that while total consumption of cigarettes remains steady at around 84 billion pieces per year, consumption of duty-paid cigarettes continues to decline. The ongoing move away from duty paid cigarettes was a little reduced in CY2001 compared with other recent years. This may be a reflection of the increased resources Customs is focusing on this area combined with a lower than usual rise in duty. More likely, however, is that this was a temporary cessation in the shift due to increased border inspection checks due to the Foot and Mouth Disease outbreak, and a short term decline in people traveling post September 11, 2001. As noted previously, but worth noting again, those who trade down to hand rolled tobacco will likely be smoking smuggled goods - around 70 percent of the RYO market is allegedly accounted for by illegal imports.

The majority of cigarettes in the UK are sold in convenience stores (more than 65 percent) with a further 27 percent sold in the major retailers.

Top 10 Brands in the UK

Brand	Market Share	Company
Lambert & Butler KS	11.6	Imperial
Benson & Hedges KS	9.3	Gallaher
Mayfair KS	5.7	Gallaher
Superkings	5.3	Imperial
Rothmans Royals KS	4.5	Rothmans (UK)
Silk Cut KS	4.4	Gallaher
Marlboro Lights KS	4	Imperial
Regal KS	3.9	Imperial
Sovereign KS	3.2	Gallaher
Embassy No 1 KS	3.1	Imperial

Trade

Most UK duty paid consumer demand is met by domestic production. Indeed, the UK maintains a positive trade balance in the cigarette market, exporting over a half all production. It is also currently holding substantial stocks. The most important export markets for the UK in value terms are Germany and Spain in the EU, Singapore, Hong Kong and South Korea in the Far East and Saudi Arabia in the Middle East. While CY2001 saw a slight decline in exports, most traders remain positive regarding CY2002 trade.

Nearly all of the UK's recorded cigarette imports come from other EU countries. In addition to the legal imports it is estimated that around 28 billion cigarettes entered the country as personal or illegal imports in CY2001, the latter

accounting for the bulk of this total. CY2001 is expected to see a further increase in the smuggled volume at the expense of duty paid imports.

Trade Matrices

Import Trade Matrix			
Country	United Kingdom		
Commodity	Tobacco, Mfg., Cigarettes		
Time period	Jan - Dec	Units:	Million pieces
Imports for:	2000		2001
U.S.	2523	U.S.	508
Others		Others	
Germany	56262	Germany	234641
Greece	8224	Netherlands	6903
Netherlands	1596	Belgium Lux	3599
Belgium Lux	1092	Ireland	211
Denmark	1067	Austria	125
France	740	France	40
Ireland	208	Hong Kong	22
Austria	41	Somalia	17
Switzerland	12	Denmark	14
Portugal	12	Switzerland	9
Total for Others	69254		245581
Others not Listed	24		56
Grand Total	71801		246145

Export Trade Matrix			
Country	United Kingdom		
Commodity	Tobacco, Mfg., Cigarettes		
Time period	Jan - Dec	Units:	Million pieces
Exports for:	2000		2001
U.S.	523	U.S.	1105
Others		Others	
Dubai (UAE)	10844	France	10314
Singapore	10301	Singapore	9981
Greece	9142	Russia	8997
Hong Kong	5826	Spain	6614
Netherlands	5649	South Korea	5949
Kuwait	5554	Netherlands	5894
Cyprus	5404	Hong Kong	5030
Saudi Arabia	5402	Nigeria	4298
France	5385	Saudi Arabia	3604
Spain	5348	Ghana	3541
Total for Others	68855		64222
Others not Listed	41628		35280
Grand Total	111006		100607

Policy Issues

Tax Policy and Prices

UK government policy towards tobacco taxes has remained largely unchanged since the Conservative government introduced the so-called escalator tax in the early 1990s, with the publicised aims of reducing consumption (particularly in children under the age of sixteen), thereby reducing the burden on the national health service of smoking-related diseases, and increasing revenue. The Labour administration, which took power in 1997 and was re-elected last year, has continued this policy with above inflation annual increases on tobacco taxes effectively becoming the norm. As such, the UK tobacco sector is one of the most heavily taxed in the world, and UK cigarette prices are the highest in the EU, with taxes accounting for around 85 percent of the retail cost of a typical packet of cigarettes. With prices approximately double those in nearby France, Belgium and the Netherlands, smuggling is a major problem.

Most Popular Price Category Cigarette across the EU (January 2002)
(Package of 20)

	Retail Price	VAT	Ad Valorem	Specific	Total Tax	Tax Incidence
UK	439	65	97	185	346	78.9
Ireland	313	52	59	135	246	78.7
Denmark	278	56	59	102	217	78
Finland	250	45	125	19	189	75.6
Sweden	253	51	99	27	177	69.9
France	225	38	124	9	171	76
Germany	198	27	46	70	143	72.5
Belgium	185	32	85	20	137	73.8
Netherlands	177	28	36	65	129	73
Austria	168	28	71	24	123	72.9
Greece	147	22	79	5	107	72.7
Italy	137	23	74	5	102	74.7
Luxembourg	140	15	66	14	95	67.7
Portugal	116	17	27	49	92	79.8
Spain	116	16	63	5	83	72

Source: Tobacco Manufacturers Association

Smuggling – Anti Smuggling Initiatives

The UK government estimates MY2000 revenue losses at BPS4.4 (USD6.3) billion split between BPS900,000 (USD1.3 billion) in legitimate cross border purchases and BPS3.5 (USD5) billion in smuggled tobacco products. These figures take into account the value of excise duty and Value Added Tax (VAT). Estimates suggest that around a

third of all cigarettes sold in the UK in CY2001 were non-duty paid. Much has been made of the losses to the retail trade as a result of smuggling.

According to industry sources, without a change in UK tax policy, the trend toward an increase in cigarette smuggling will continue. The industry's position is that the high incidence of smuggling has made low priced cigarettes widely available (black market prices range from BPS2.00-2.50 per pack) and therefore reduced the effectiveness of UK tax policy in curbing smoking. Indeed, they argue that the UK tax policy is exacerbating the switch by many consumers to non-duty paid cigarettes, thereby reducing the tax revenue collected.

Anti-smoking initiatives

The UK government has made reducing the incidence of smoking a key health objective. In addition to its policy of high taxes, it has supported wholeheartedly various EU directives to curb smoking.

Although the anticipated UK government Bill banning virtually all advertising, possibly including in-store and window displays, did not materialize in CY2001 in England and Wales, similar stiff measures remain a possibility in Scotland. Even in England and Wales, many consider the failure of the Bill to be a short term reprieve, the UK government perhaps waiting on the European Parliament, who are currently re-drafting proposed anti-advertising legislation defeated in October 2000, before announcing their next move.

The UK government's introduction of a duty paid mark on cigarettes and hand rolling tobacco, the two main smuggling problem areas, as of July 1, 2001 has had debatable success. Many consider the new measures to be cosmetic and dispute whether they have had any effect on smuggling. Previously, non-UK origin packets of cigarettes could invariably be spotted by the language of the health warning.

The UK industry is also paying much attention to a possible piece of EU legislation which could see terms such as "Lights", "Mild" and "Ultra" being banned. This would affect six of the top twenty brands in the UK which currently include such descriptions in their name. With cigarettes sold in packets of 10 also reported to possibly be facing outlaw, the UK industry is understandably concerned.

Other Products

Roll Your Own (RYO)

The RYO market is the second most important tobacco market in the UK with around 5.5 million regular smokers and around 1 million dualists (those who smoke RYO and cigarettes). In recent years its popularity has grown as the cost of duty-paid cigarettes has continued to rise. Further, as an area that traditionally attracted an older clientele, it is interesting to note that it is becoming increasingly popular among young smokers. This becomes even more interesting given that market research indicates that once smokers have switched to RYO they are unlikely to switch back to cigarettes. The same manufacturers are producing this product with Gallaher's Samson and Imperial's Golden Virginia and Drum among the most popular brands. The latter introduced a 25 gram pouch in CY2001 to specifically appeal to younger smokers. In CY2001, it is estimated that around 70 percent of the RYO products on the UK market were non-duty paid, having either been smuggled into the country or legitimately imported by individuals for personal consumption. Unofficial estimates suggest that of the total 9,000 tons consumed, around 2,775 tons were duty paid. Although consumption was down slightly in CY2001, the RYO market is expected to continue to remain very popular as long as UK cigarette taxes remain high.

Cigars

The UK cigar market is worth approximately BPS500 (USD750) million, with consumption in CY2001 totalling approximately 900 million cigars. Overall cigar consumption has been in slow decline for a number of years in the UK. However, within the sector, small cigars have been gaining at the expense of standard and large cigars and, with a growth of around 15 percent in CY2001, now account for around one third of all sales in the sector. This compares with a fifth five years ago. By CY2003 many expect small cigars to account for 45 percent of all cigar sales with increasing numbers of cigarette smokers partaking in the occasional small cigar. Indeed, such is the success of small cigars that the sector actually saw growth of circa 1.5 percent in value terms in CY2001 despite the fall in volume purchases. Gallaher's Hamlet brand continues to dominate the sector, its position further boosted by the redesign of its five packs in early 2001 and the replacement of its ten packs with (increasingly popular) tins towards the end of the year. Second, third, fourth and fifth places are taken by Imperial's Classic, Panama, King Edward Coronets and Henri Winterman's Café Creme brands giving it the dominant company market share.

Pipe Tobacco

The pipe tobacco sector remains in decline, down 10 percent on CY2000. With around 450,000 pipe smokers in the UK consuming between 650-750 MT of tobacco in CY2001, the market was estimated to be worth around BPS85 (USD120) million. Imperial's St Bruno Ready Rubbed remains the best seller. As a niche market, characterised by older smokers, the market is expected to continue to shrink.

Appendix

Cigarettes PSD

PSD Table						
Country	United Kingdom					
Commodity	Tobacco, Mfg., Cigarettes				(MIL PCS)	
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		01/2000		01/2001		01/2002
Filter Production	149750	125855	149750	125891	0	125750
Non-Filter Production	250	250	250	250	0	250
TOTAL Production	150000	126105	150000	126141	0	126000
Imports	45018	68913	54000	58189	0	60000
TOTAL SUPPLY	195018	195018	204000	184330	0	186000
Exports	111006	111006	120000	100607	0	102000
Domestic Consumption	84012	84012	84000	83723	0	84000
TOTAL DISTRIBUTION	195018	195018	204000	184330	0	186000